regulation, the states also embraced the same consumer interest and pro-competition benefits that the Commission underscored when it abandoned rate-of return regulation.[42]

IV. THE "REALITY" OF COST ASSIGNMENT

The Commission's cost assignment rules played a critical role in setting rates under rate-of-return regulation; they were created precisely to ensure that rates reflected actual costs and thus were "strongly connected" to achieving the goal of "just and reasonable" rates. However, the cost assignment rules no longer play this role for BST which is subject to price cap regulation in both federal and state jurisdictions. Under price caps, the cost assignment rules have no connection to ensuring that BST's rates are "just and reasonable." While BST meticulously complies with all the Commission's cost assignment rules today, ignoring these rules completely would have no impact on BST's prices under price cap regulation.

Chart 3 illustrates the relationship of costs and rates today and makes clear that the price cap process is entirely separate from the flow of data under the cost assignment rules; they do not interconnect anywhere. The end result of the cost assignment rules for BST is not "the establishment of rates," but rather the population of certain ARMIS reports (and various state informational reports), which are not used for ratemaking purposes. Since the results of the cost

---

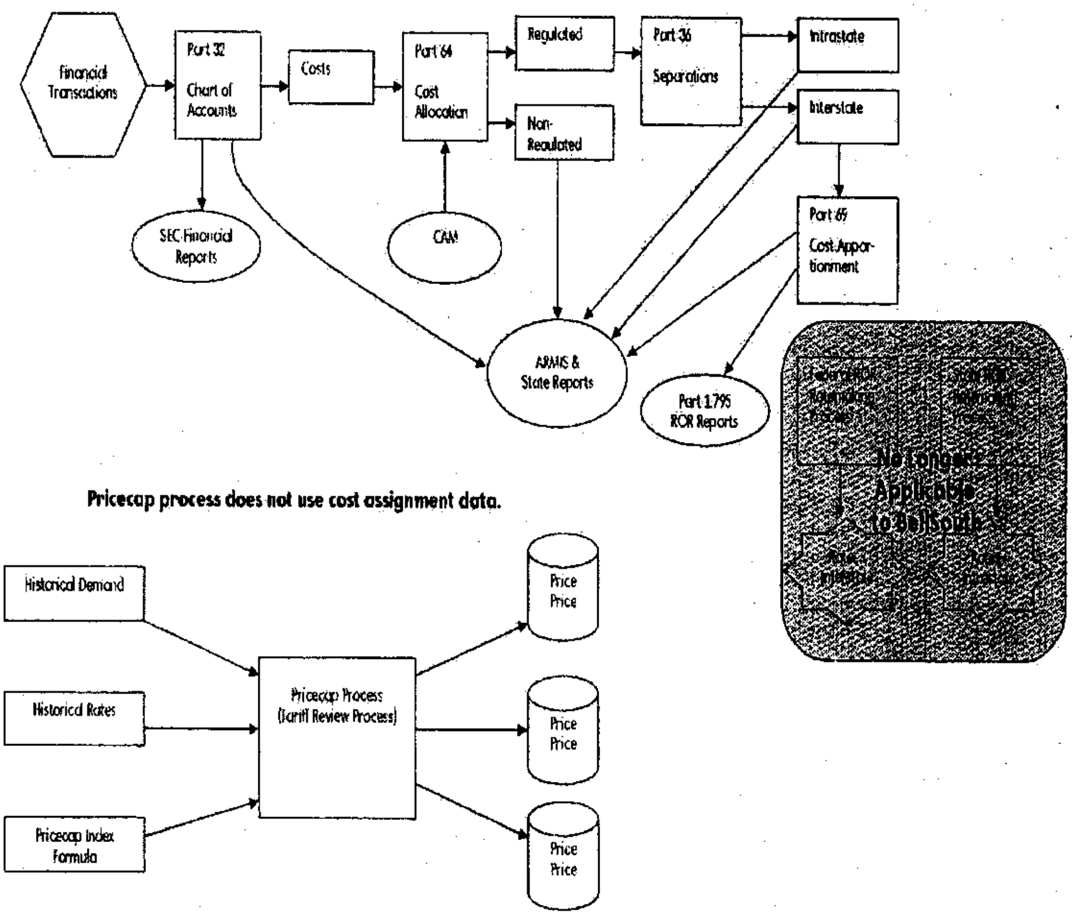
various aggregated categories of services, based upon changes in generally accepted indices of prices").

[42] *See, e.g.*, Ga. Code Ann. § 46-5-161(a)(1) (2005) ("It is in the public interest to establish a new regulatory model for telecommunications services in Georgia to reflect the transition to a reliance on market based competition as the best mechanism for the selection and provision of needed telecommunications services at the most efficient pricing");Tenn. Code Ann. § 65-4-123 (2005) (noting the policy in adopting price regulation in Tennessee "to foster the development of an efficient, technologically advanced, statewide system of telecommunications services by permitting competition in all telecommunications services markets, and by permitting alternative forms of regulation for telecommunications services and telecommunications services providers").

assignment rules are no longer necessary to ensure just and reasonable rates they cannot be shown to have any connection to their original permissible regulatory purpose.

3. Costs and Ratemaking Today

Today, results of cost assignment rules flow only to reports.



Now that it has been established that the cost assignment rules no longer serve their original purpose, one must ask: what is the affect of continuing to require BST to comply with these rules? What is the "reality" of the cost assignment rules today? The answer is that the cost assignment rules create a clear and negative regulatory "chokepoint" that prevents BST from competing fully and effectively in today's broadband/IP/multi-technology platform environment.

Today's customers are demanding innovative services; vendors are rolling out multi-function products; digital packet-based network technologies are offering increased flexibility and capacity. Into this environment, BST is forced to try to shoehorn compliance with cost assignment rules designed for an analog, single purpose, circuit switched network. While its unencumbered competitors can take services directly from the drawing board to their customers, BST must go from the drawing board to a cumbersome cost assignment analysis to determine how to allocate virtually every piece of equipment, every facility, and every human resource that will be involved in the service. A service cannot be offered to a customer until it can be accounted for in compliance with the Commission's cost assignment rules. This process can delay the introduction of new services for as much as six months and in some cases prevents them from getting to market at all.

How can compliance with the cost assignment rules have such a dramatic effect on BST's ability to offer new services and operate efficiently? The following section focuses on one of the primary sets of rules at issue in this Petition and, more importantly, the impact of those rules on day-to-day activities of BST employees and product development teams. A close look at the actual requirements and several examples of the experience of complying with them underscore the "chokepoint" effect of these rules, without the need to delve into the details of the impact of all of the Commission's cost assignment rules.

A. <u>Assignment of Costs to Regulated and Non-regulated Activities (§§ 32.23 and 64.901).</u>

1. <u>The rules</u>

Section 32.23 establishes the basis for allocation of Part 32 investment and expense accounts into regulated and nonregulated activities and describes the accounting treatment of activities classified for accounting purposes as nonregulated. Section 32.23(c) states, in pertinent part:

> When a nonregulated activity does involve the joint or common use of assets and resources in the provision of regulated and nonregulated products and services, carriers shall account for these activities within accounts prescribed in this system for telephone company operations. Assets and expenses shall be subdivided in subsidiary records among amounts solely assignable to nonregulated activities, amounts solely assignable to regulated activities, and amounts related to assets and expenses incurred jointly or in common, which will be allocated between regulated and nonregulated activities. Carriers shall submit reports identifying regulated and nonregulated amounts in the manner and at the times prescribed by this Commission.[43]

Implementation of Section 32.23 is further codified in Part 64, subpart I. Section 64.901(a) begins the process by requiring BST to "separate [its] regulated costs from nonregulated costs" by using "the attributable cost method of cost allocation." The attributable cost method requires that costs be assigned or allocated on a cost causative basis through a complex hierarchy of allocation factors. This necessitates that BST review each and every service that it offers in order to determine whether it includes a nonregulated component. This review includes underlying operational support.

---

[43] 47 C.F.R. § 32.23.

If a given service does incorporate a nonregulated component, BST must then follow the allocation process established by the *Joint Cost Order* and codified in Section 64.901(b)(1), which provides as follows:

> (b) In assigning or allocating costs to regulated and nonregulated activities, carriers shall follow the principles described herein.
>
> (1) Tariffed services provided to a nonregulated activity will be charged to the nonregulated activity at the tariffed rates and credited to the regulated revenue account for that service. Nontariffed services, offered pursuant to a section 252(e) agreement, provided to a nonregulated activity will be charged to the nonregulated activity at the amount set forth in the applicable interconnection agreement approved by a state commission pursuant to section 252(e) and credited to the regulated revenue account for that service.[44]

Section 64.901(b)(1) requires BST to assign a cost value of a tariffed (*i.e.*, regulated) service used to provide the nonregulated service. Under this rule, when a nonregulated service uses a regulated tariffed service (or a service that is offered pursuant to an interconnection agreement filed with a state commission) the regulated side of the business must charge the nonregulated service the rate established in the tariff (or the interconnection agreement).

Most of BST's nonregulated services are provisioned over network facilities that are not separately identifiable or discretely tariffed. This is particularly true of services which use technologies, such as packet-switching, that are almost impossible to separate and track as the rules require. However, the costs associated with these facilities when used by a nonregulated service must be identified and allocated. This allocation must be done to a minute level of detail to enable the Part 32 accounts containing these costs to be allocated between regulated and nonregulated. Sections 64.901 (b) (2) and (3) establish the allocation process. These rules state:

> (2) Costs shall be directly assigned to either regulated or nonregulated activities whenever possible.

44 47 C.F.R. § 64.901 (b) (1).

> (3) Costs which cannot be directly assigned to either regulated or nonregulated activities will be described as common costs. Common costs shall be grouped into homogeneous cost categories designed to facilitate the proper allocation of costs between a carrier's regulated and nonregulated activities. Each cost category shall be allocated between regulated and nonregulated activities in accordance with the following hierarchy:
>
>> (i) Whenever possible, common cost categories are to be allocated based upon direct analysis of the origin of the cost themselves.
>>
>> (ii) When direct analysis is not possible, common cost categories shall be allocated based upon an indirect, cost-causative linkage to another cost category (or group of cost categories) for which a direct assignment or allocation is available.
>>
>> (iii) When neither direct nor indirect measures of cost allocation can be found, the cost category shall be allocated based upon a general allocator computed by using the ratio of all expenses directly assigned or attributed to regulated and nonregulated activities.[45]

To allocate costs to regulated or nonregulated operations in accordance with these rules, BST had to design and develop an extensive cost allocation system to accommodate these requirements. This system must identify all costs that are used exclusively for specific regulated or nonregulated activities, while the remaining costs must be grouped into homogeneous cost categories and then allocated on some basis that best reflects the cost causative nature of the cost. The granularity and methodology of allocation required for Part 32 accounts varies depending on the complexity and the availability of functional cost information.

The structure of allocation methodology, thus, differs for each of more than 100 accounts that are publicly reported via the Commission's ARMIS 43-03. For BST, the allocation of these Part 32 accounts requires the use of approximately 400 cost pools following the analysis required

---

[45] 47 C.F.R. §§ 64.901 (b) (2) and (3).

by the Commission's Part 64.901 Rules. Before introducing a new service, or modifying an existing service, BST must analyze the costs that are recorded for each Part 32 account and determine the nature of those costs and whether the accounts include costs that are dedicated to or shared between regulated and nonregulated BST operations.

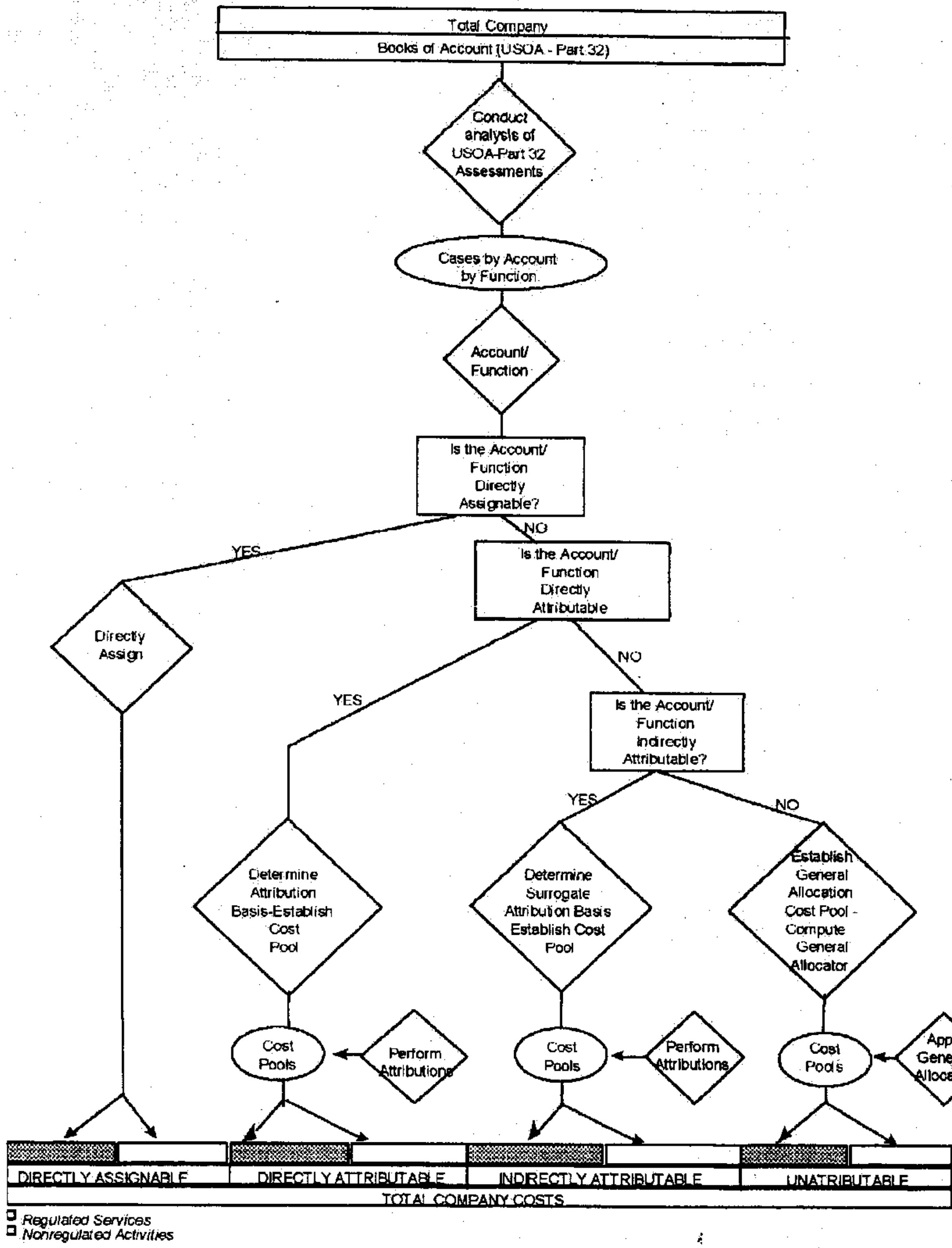
The Commission's Part 64.901 cost apportionment rules require this analysis to be based upon a cost causal relationship which drives the division of cost between four types of cost pools: Directly Assigned, Directly Attributable, Indirectly Attributable, and Unattributable. The rules require direct assignment to the maximum possible extent. Accordingly, every effort is made to find a direct link between regulated or nonregulated operations to be able to Directly Assign costs. When that direct link is absent, BST must make an extensive effort to determine a direct attribution method that closely links the cost to the regulated or nonregulated operations. Special studies and statistical samples are performed in many cases in order to achieve direct attribution.

If direct attribution cannot be achieved for certain costs, BST must research indirect attribution methods. The Commission requires minimal use of the General Allocator or Marketing Allocator in apportioning any Unattributable costs. As a practical matter, this makes the process more involved, but BST makes every effort to avoid the use of that allocator.

Although BST has instituted an extensive array of accounting codes and systems in order to comply with the Part 64.901 hierarchy, new products and services present a challenge to this hierarchy. Thus, each time BST seeks to bring new products and services to consumers, it must first review the existing array of codes to determine applicability. If, as is often the case, the codes do not fit, new apportionment methods and corresponding codes must be developed and implemented. These processes typically take numerous employees several months to accomplish.

The following "Cost Allocation Flow Chart" depicts the processes described above. The chart illustrates how costs flow from their inception through BST's accounting system to allocation into regulated and nonregulated activities. Also attached, as further illustration of these requirements, is Appendix 3, which is one cost apportionment table for accounts 6112-6441 of BST's Part 32 accounts broken down by cost pools and indicating the basis of allocation for the account, *i.e.*, Directly Assigned, Directly Attributed, Indirectly Attributed, or Unattributable.

COST ALLOCATION FLOW CHART



2. Day-to-Day Operational Impact of Sections 32.23 and 64.901.

In today's world, engineers design integrated communications networks in order to take advantage of the efficiencies of new technologies. Consumers demand service packages that allow them to reap cost savings and the benefits of innovation. The artificial divisions that legacy cost assignment rules require are not only unrelated to determining rates in a price cap environment, but also represent a formidable obstacle to meeting the demands of the evolving marketplace and giving consumers the innovative products and services they desire. The following examples illustrate the many activities that routinely occur throughout BellSouth in an effort to ensure compliance with these now unnecessary and outdated rules without any corresponding public benefit.

a. Network assets used in service offerings

Increasingly, consumers are demanding products and services that entail substantial convergence of regulated and nonregulated network assets (or, in the case of service bundling, convergence of tariffed and non-tariffed services). Whenever a new service is proposed that uses network assets, BST must work extensively to ensure the proper allocation of costs between its regulated and nonregulated books in relation to every aspect of that service. The more complex the network topology, and the more convergence between regulated and nonregulated assets and resources in providing the service, the more cost allocation hurdles there are for BST to jump. If outside vendors provide any of the service elements, of course, then BST must ensure that those vendors develop cost allocation measurements for these elements.

Typically, the result of the rules' application is a morass of regulatory allocation "chokepoints" that BST must navigate before marketing such products or services. This means that specific, interested customers -- or the market more generally -- must wait substantially longer for BST's offerings than would otherwise be necessary if the rules did not apply. Sometimes, customers decline to do so.

The foundation of BST's network of the future is the BellSouth Regional IP Backbone ("BRIB"). To begin the transition today, BST would like to migrate new ATM and Frame Relay customers to the BRIB. Unfortunately, the cost assignment rules get in the way. ATM and Frame Relay services are regulated and the BRIB is unregulated, so they cannot coexist without complying with the allocation rules. Adding to the complexity, these services can involve local and long distance services, which invoke the affiliate transactions rules, which are described more fully below. Identifying relative usage or some other method of allocating and assigning to affiliates costs of equipment shared among these packet-based services is a challenge. The effort and expense in creating some distinction among these packets in order to comply with regulatory cost assignment mandates serve no network purpose and serve only to add complexity and cost.

As computing power increases, network devices such as servers, routers and aggregation hardware that BST is deploying are able to combine traditionally regulated and non-regulated functions. Combining these functionalities offers substantial network operations efficiencies. However, before being able to deploy these devices in the network and take advantage of the more powerful customer features and lower costs they bring, BST must pass such deployment decisions through the chokepoint of the cost assignment rules. Single devices that integrate regulated and non-regulated functions must be split, allocated according to some formula and properly billed to affiliates. Cost allocation software can be written and added to a device CPU to distinguish between regulated and non-regulated uses, but doing so serves no network or consumer functionality.

Cost assignment rules that force engineering focus on separating bits into regulatory buckets instead of on creating more efficient networks and better functionality are not in the public interest. The cost assignment rules create significant complexity around IP-based services such as IPTV and VoIP, for example, as these information services must pass through the cost assignment rules chokepoint before further rollout decisions can be made.

One of BST's recent product development experiences provides a good example of the failure of the rules to deliver for consumers. In 2003, BST began developing a service offering known as Intelligent Data Service Unit ("IDSU") service. In simple terms, IDSU was designed to provide BST's wholesale customers with greater visibility of their networks (*i.e.*, traffic on the customer's local loops). Combined with BST's tariffed frame relay/ATM network management service (which provided network management functionality for traffic within BST's network or "cloud"), IDSU would give the wholesale customer complete, end-to-end information about its network (*i.e.*, from the customer's end user, through BST's cloud and then onward to its destination). By giving the wholesale customer a total picture of its traffic, and not merely the portion within BST's cloud, IDSU would provide that customer much greater ability to monitor and manage the health of its network.

A diagram of IDSU is provided as Appendix 5. The diagram depicts the elements of the IDSU network topology and the points where allocations decisions must be made. These elements and areas include, among other things, a number of processors and servers, several hardware platforms, equipment housing requirements in BST facilities, systems administration and help desk functions, communications links, and various other functions.

The network design and engineering for the IDSU service was certainly challenging, as the diagram suggests. Adding significantly to that challenge, however, was the fact that *a* *separate, detailed cost allocation analysis and decision was required for each and every cost allocable aspect of the service* (thirteen in all). Further, the rules required the *use of different cost allocation methodologies* depending on the nature of the service elements under cost allocation analysis. And, of course, the results of the allocations ultimately served no ratemaking function and provide no customer benefit.

The cost allocation issues that arose in the IDSU project development substantially contributed to several months of delays in finalizing the service for delivery. At the time the allocations process for the IDSU service began, BST had a wholesale customer waiting for the service. The production delay proved costly, however: by the time the allocations processes were completed, the customer had been lost.

b. Advertising

Cost assignment rules greatly complicate even basic tasks like advertising services to potential customers. Because customers are interested in multiple communication services and packages, BellSouth's advertising, like that of its competitors, typically provides consumer information about multiple communications services. Unlike its competitors, prior to placing an ad, BST must attach regulated, nonregulated and affiliate transaction labels to each service mentioned in an ad, and then allocate the costs of the ad according to those labels. Appendix 4 contains several examples of print ads that BST has recently run. BST runs over 2500 different ad pieces every year. A simple decision to include multiple services in a single advertisement brings with it the costs and distractions described below.

In order to allocate the costs of all multi-service print, television, radio and other ads between various services and affiliated companies, BST pays outside vendors and employees to review every line of advertisement text to determine how the advertising costs should be charged its application to affiliates, as required by Part 32.27, or allocated between services, as required by Part 64.901. Take the two page consumer mail ad reproduced at Appendix 4 (pp. 4 and 5). The following services appear in the ad: local service, Complete Choice (a bundle of local service features), DSL, Wireless, Long Distance and Direct TV. One page is reserved for the address and a photo. The question facing the ad agency employee reviewing the ad is how to allocate the costs among all these services. As the Appendix shows, the solution is to read the ad, count the total number of words and then count the number of words associated with each product. The ad has 1,005 words. 621 words are associated with local service, 107 with Complete Choice, 37 with DSL and 13 with wireless service, 43 words are associated with long distance and 184 with Direct TV. White space and common areas are allocated in proportion to the word counts. Radio and television ads are allocated similarly, but instead of counting words, people with stopwatches time the ads and the amount of time spent on each service.

Once the words are counted and the common space allocated, the ad agency prepares an invoice charging the cost of the ad among regulated and non-regulated services and to affiliates such as BellSouth Long Distance. This invoice and the underlying documentation are reviewed for accuracy by a BellSouth advertising manager and by a supervisor. A BellSouth finance employee provides a final review of the allocation and the backup data. The supporting documentation for a single print ad campaign fills a half-inch binder. Finally, an independent auditor, as part of the CAM audit, audits the entire allocation process.

There is no *de minimis* standard: the rules apply regardless of the size of the advertisement or the cost involved, and BellSouth must engage in this exercise for an advertising agency charge as small as $1,000. And, the cost apportionment review described must be performed for the over 2500 different ad pieces that BellSouth produces each year.[46]

c. **Time reporting**

The cost assignment rules that cause people to count words in print ads and time radio ads with a stopwatch apply just as much to BST's employees as to advertising expenditures. That is, just like ads that contain multiple services, and a network that delivers them, BST (and BellSouth) sales reps, network engineers, science and technology planners and human resources and regulatory employees work on multiple services – some regulated and some not. In order to comply with cost allocation requirements, BST must keep separate track of every employee's regulated and nonregulated activities. Cost allocation touches every employee at BST, and requires every supervisor to review the allocation of employee time between regulated and nonregulated activities, and finance and accounting personnel to calculate the actual cost charges. This is not productive activity.

Appendix 6 illustrates what it means to allocate time among the various buckets created by the cost assignment and affiliate transaction rules. Customer service representatives ("CSRs") can and do provide consumers with information about multiple services over the telephone. Some services are regulated, some are not; some are provided by affiliates, and some not. The cost assignment rules require that CSR time be properly split out and accounted for.

In order to do this, BST employs a statistician to devise a statistically significant CSR time sampling plan. The plan involves a monthly schedule of call center locations to monitor. BST then hires observers to monitor individual CSR calls according to this plan. These observers listen in to customer calls and, with a split stopwatch, time the length of the call and

[46] Appendix 4 contains a flow chart and supporting information depicting this process in more detail.

the amount of time spent on each of the different regulatory buckets. Data is collected and analyzed.

A sample of a CSR time analysis spreadsheet is contained in Appendix 6, p. 2. As displayed in that spreadsheet, this expense and effort yields the information that CSRs spent 4.04% of their time on basic inside wire in Alabama in the period March-May of 2005. CSRs spent 4.53% of their time during that period in Florida on Memory Call, and 18.08% on Internet services.

These data go into cost allocation formulas which are used to allocate CSR time among various services and to charge affiliates. Of course the underlying CSR studies, statistical sampling plan and results are subject to regular audit as part of the CAM audit. The results are only used to populate the ARMIS 43-03 report, but are not used for ratemaking purposes.

d. **Floor space**

A different but no less telling example of the complications caused by the Commission's rules is the allocation of floor space, which is an extraordinary process mandated by the *CAM Uniformity Order*.[47] In that order, the Bureau sought to establish uniform practices among CAM-filing LECs, which included ordering nine specific cost pools and associated methodologies to allocate building costs based on how such buildings are used.

To comply with the *CAM Uniformity Order*, BST must prepare detailed floor space maps for its buildings. These maps, examples of which are attached as Appendix 7, reflect the total floor space and the proportion of such floor space being used by BST and its affiliates. BST

[47] *Implementation of Further Cost Allocation Uniformity*, AAD 92-42, 8 FCC Rcd 4664, Memorandum Opinion and Order (1993) ("*CAM Uniformity Order*").

must prepare these maps, *down to the square foot,* for the over 33 million square feet of floor space in over 700 office buildings.

After these maps are prepared, BellSouth must monitor all employee moves. When an employee or group of employees moves, BellSouth updates its records monthly to accurately reflect the floor space used by BST and that used by BellSouth affiliates.

Because of the work effort involved in updating these records, which include preparing new floor space maps, every employee move must be approved or denied by a cost allocation oversight group. Not infrequently, a move request is denied simply because the cost of complying with the accounting rules outweighs the efficiency that would otherwise be gained by moving the employee or group of employees.

As required by the Commission, BST must perform an annual study, at its own expense, to verify its floor space records and the resulting allocation of costs. The actual floor space analysis entails, among other things, the hiring of a statistician to perform sampling studies of BellSouth's building space.[48] Typically, 150 buildings are surveyed annually. Completion of the floor space analysis alone generally involves 40 BellSouth managers, who must take time away from their normal real estate management duties, and requires approximately 1500 hours of their time.

[48] *CAM Uniformity Order,* 8 FCC Rcd at 4666-67, ¶¶ 19-22.

B. Other Unnecessary Cost Allocation Rules.[49]

1. Sales of services and asset transfers between BST and its affiliates (§ 32.27).

In addition to the Part 32.23 and Part 64, subpart I, requirements for cost allocation, BST also must comply with Section 32.27 regarding affiliate transactions. Section 32.27 governs how BST must account for assets and services transferred between itself and any of its nonregulated affiliates. The purpose of the rules was to ensure that ILECs did not record the purchase of assets or services from an affiliate at too high a price and then pass that cost on to the ILEC's ratepayers. In addition, the rules were intended to keep an ILEC from recording services or assets sold to an affiliate at suspiciously low prices and subsequently passing on the cost under-recovery to ratepayers. Since adoption of price caps in both federal and state jurisdictions, the costs BST records on its books as a result of these affiliate transaction rules do not "pass through" to any rates and thus no longer serve the intended ratepayer protection role. Today, the results of these rules are solely to populate ARMIS reports.

The rules governing sales of services (32.27(c)) require that every service provided between BST and a nonregulated affiliate[50] must be analyzed individually according to the Commission's three-step hierarchy before the transaction can be recorded. In the first step, if a tariff or interconnection agreement exists for the service then the transaction is recorded at that rate. If no tariff, or equivalent, is available then BST follows the second step and records the

---

[49] Although the rules discussed below are as vital to this Petition for Forbearance as the others, BST, in the interest of brevity, will confine this discussion more narrowly. BST is fully prepared, of course, to provide detailed examples of rules' applications for each of the scenarios now described.

[50] BST's CAM includes seven pages of descriptions of assets and services provided between BST and its nonregulated affiliates. Examples are office space, procurement, security, training, and insurance support.

services at the prevailing market price (providing such a price can be established only by sales of more than 25% to third parties.)

When neither the first or second step of the hierarchy can be met, BST must move to the third and most complex step. Fully Distributed Cost (FDC) must be established for each of these transactions. This requirement means that, not only BST, but also otherwise nonregulated affiliates must maintain a costing system based upon 64.901 of the Commission's rules in order to ensure BST's compliance with 32.27. Nonregulated affiliates that are designed to provide services only within the corporate family pass this FDC information to BST for the transaction recording.

If the affiliate has services offered to external customers as well as affiliates and the total sales of the services provided to affiliates is less than $500,000 annually, the FDC is provided to BST for the recording of that service. If BST has external sales below the $500,000 benchmark, the service is recorded at FDC. If the affiliate or BST has sales for the service in excess of $500,000, the third step of the hierarchy becomes more complex. For each of these services Estimated Fair Market Value (EFMV) must be compared against FDC.[51] Each EFMV study typically costs more than $100,000 and takes several months to produce. The rules require that such a service transaction from BST to a nonregulated affiliate must be recorded at the higher of EFMV or FDC; a service transaction from an affiliate to BST must be recorded at the lower of EFMV or FDC.

The sole purpose of calculating FDC and paying for an EFMV study is to compare the two values and record the lower or higher value on the books as the cost of the transaction. Regardless of which value is recorded, the cost has no impact on BST's prices set *via* price caps.

[51] In 2005, BST has 18 services that fall within this category of affiliate transactions.

A very similar process is required for assets transferred between BST and affiliates, except that the comparison is between EFMV and Net Book Costs. Ironically, if BST has to record an asset transfer at EFMV to comply with FCC rules, it must also maintain records for these transfers at Net Book Cost to comply with Generally Accepted Accounting Principles (GAAP). GAAP requires that all public companies transferring assets between affiliated entities record those transactions at Net Book Cost.[52]

2. <u>The "CAM"and independent audit requirements (§§ 32.9000, 64.903 and 64.904).</u>

BST is required to file a Cost Allocation Manual every year in December and whenever there are significant modifications.[53] The CAM, the preparation of which is governed by Section 64.903, must describe how BST separates regulated from non-regulated costs and must contain the following: (1) a description of each of the carrier's non-regulated activities; (2) a list of all incidental activities; (3) a chart showing all corporate affiliates; (4) identification of each affiliate that has transactions with BST and the nature of those transactions; (5) cost apportionment tables for each Part 32 account that contains costs; and (6) a description of all time reporting procedures BST uses. Although these filings are subject to public comment, no third-party has filed comments on BST's CAM or any CAM revision since 1991.

Moreover, pursuant to Section 64.904,[54] BST's CAM is audited for compliance with each of the Part 64, subpart I rules as well as the affiliate transactions rules. BST must hire an outside

---

[52] FAS 141, paragraph D12. "When accounting for a transfer of assets or exchange of shares between entities under common control, the entity that receives the net assets or the equity interests shall initially recognize the assets and liabilities transferred at their carrying amounts in the accounts of the transferring entity at the date of transfer."

[53] 47 C.F.R. § 32.9000. SBC, Verizon, and Qwest are the other three companies that continue to have a CAM filing obligation.

[54] *See* 47 C.F.R. § 64.904.

auditor at a cost of over $1 million per year to conduct this exhaustive audit.[55] The auditors and BellSouth employees spend several months every year scrutinizing the records to confirm that every cost allocation rule is followed down to its strictest detail. Given that cost allocation rules are no longer "strongly connected" to their original purpose, it is ironic that these are the only FCC rules which are subject to such a rigorous audit requirement.

C. **Jurisdictional Separations (Part 36).**

Jurisdictional separations is "the third step in [the] four-step regulatory process that begins with an ILEC's accounting system and ends with the establishment of rates . . . ."[56] Under the jurisdictional separations process, BST must allocate regulated costs between the intrastate and interstate jurisdictions. The astonishingly detailed methodology developed to undertake this process is on display in the 86 pages of separations rules contained in Appendix 1.

The original purpose of jurisdictional separations was to prevent ILECs from recovering the same costs in both the interstate and intrastate jurisdictions. This concern and, thus, this purpose were only valid under rate-of-return regulation where costs could have a direct impact on rates. For BST, the need for a separations process evaporated when both federal and state regulators moved to pure price cap regulation.

---

[55] The independent audit requirement was originally designed to aid the Commission in fulfilling its responsibility to ensure that carriers complied with the Commission's rules. However, the Commission exempted mid-size carriers from performing these independent audits to "significantly lighten regulatory burdens," even though many of these carriers are rate-of-return regulated. *2000 Biennial Regulatory Review – Comprehensive Review of the Accounting Requirements and ARMIS Reporting Requirements for Incumbent Local Exchange Carriers: Phase 2; Amendments to the Uniform System of Accounts for Interconnection; Jurisdictional Separations Reform and Referral to the Federal-State Joint Board; Local Competition and Broadband Reporting*, CC Docket Nos. 00-199, 97-212, 80-286 & 99-301, *Report and Order in CC Docket Nos. 00-199, 97-212, and 80-286; Further Notice of Proposed Rulemaking in CC Docket Nos. 00-199, 99-301, and 80-286*, 16 FCC Rcd 19911, 19980, ¶ 189 (2001).

[56] *In the Matter of Jurisdictional Separations and Referral to the Federal-State Joint Board, supra*, at ¶ 3.

The Commission itself has raised questions about the continued need for separations for price cap carriers,[57] particularly in an era of rapidly changing technology that is blurring formerly clear jurisdictional boundaries between services. As a result, and upon recommendation of the Federal-State Separations Joint Board, the Commission adopted an interim freeze on its jurisdictional separations rules effective July 1, 2001.[58] Specifically, the Commission placed a freeze on Part 36 category relationships and jurisdictional allocation factors for price cap carriers.[59]

In imposing the freeze, the Commission noted the "rapid changes in the telecommunications infrastructure, such as the growth in Internet usage and the increased usage of packet switching," "other new technologies, such as digital subscriber line (DSL) services, as well as a competitive local exchange marketplace." These developments, the Commission properly observed, were "not sufficiently contemplated by the current Part 36 rules."[60]

The Commission concluded that a freeze of the separations process would "reduce

---

[57] *Jurisdictional Separations Reform and Referral to the Federal-State Joint Board*, CC Docket No. 80-286, *Notice of Proposed Rulemaking*, 12 FCC Rcd 22120, 22140, ¶ 41 (1997).

[58] *Jurisdictional Separations Reform and Referral to the Federal-State Joint Board*, CC Docket No. 80-286, *Recommended Decision*, 15 FCC Rcd 13,160; *Jurisdictional Separations and Referral to the Federal-State Joint Board*, CC Docket No. 80-286, *Report and Order*, 16 FCC Rcd 11,382 (2001) ("*Separations Freeze Order*").

[59] "Category relationships" are the percentage relationships of each Part 36 category to the total amount recorded in its corresponding Part 32 account(s). *See* 47 C.F.R. Part 32, Part 36. "Jurisdictional allocation factors" are the percentage relationships that allocate costs assigned to Part 32 accounts for jointly used plant between the interstate (federal) and intrastate (state) jurisdictions. *See Id.*

[60] *Id.* The Commission noted that the increased use of packet-switching "may call into question the continued validity of usage-based separations procedures designed for circuit-switched technologies and services." Because packet switching enables a single transmission path to carry packets from many different customers during the same period, while circuit-switching requires a dedicated single transmission path to one customer for the duration of a call, the Commission observed that its "Part 36 rules do not appropriately address the allocation methods for these newer technologies." *Id.*

regulatory burdens on carriers during the transition from a regulated monopoly to a deregulated, competitive environment in the local telecommunications marketplace."[61] Because only ILECs are required under the Part 36 rules to perform separations studies, while CLECs have no similar requirements, the Commission found that a freeze would further its stated goal "of achieving greater competitive neutrality during the transition to a competitive marketplace by simplifying the separations process for those carriers subject to Part 36."[62] The Commission, thus, recognized that continued application of the separations process was inconsistent with a technologically evolving, and increasingly competitive marketplace.

Since the Commission adopted the separations freeze in 2001, the trends that it cited in support of that action have accelerated at a pace more rapid than anyone imagined. Driven by wireless and IP technologies, the telecommunications marketplace is far more competitive today than in 2001 and many more services and service bundles have been deregulated. "Internet usage" has not just grown, it has transformed into a full-fledged roll-out of IP networking technologies, multi-function facilities, and services such as VoIP and IPTV. These were clearly not "sufficiently contemplated" by the Part 36 rules and that fact, combined with today's price cap regulation, demonstrates the appropriateness of granting BST forbearance from the separations rules.

D. <u>Part 69 Interstate Cost Apportionment Rules.</u>

The final step in rate-of-return ratemaking is setting rates across the LEC's services. The purpose of the Part 69 rules was to apportion separated interstate regulated costs among interstate access service categories. The apportioned costs represented the fully distributed costs of the access categories and, prior to price caps, the cost basis upon which interstate access rates were

---

[61] *Separations Freeze Order,* 16 FCC Rcd 11,382 at ¶ 13.

[62] *Id.*

set. These costs were used to calculate the interstate rate-of-return on the different interstate access categories. With the adoption of price cap regulation, such costs no longer are used for rate-setting. Thus, the cost apportionment rules, like the separations rules from which they extend, are not connected to price cap ratemaking, and, frankly, serve no other legitimate regulatory purpose in BellSouth's case.

V. DISCUSSION

Under 47 U.S.C. § 160, the Commission must grant BST's Petition for Forbearance if it determines that: (1) enforcement or application of the Commission's cost assignment rules are not "necessary to ensure that ... [BST's] charges ... are just and reasonable and are not unjustly or unreasonably discriminatory;" (2) enforcement or application of the rules at issue is not "necessary for the protection of consumers;" and (3) forbearance from the rules' application is "consistent with the public interest."[63] BST's Petition satisfies each of these elements.

A. The Commission's Cost Assignment Rules Are Not Necessary To Ensuring That BST's Rates Are Just, Reasonable, And Nondiscriminatory.

No dispute exists that BST's interstate and intrastate rates are regulated under price cap regulation, rather than rate-of-return regulation. It is equally beyond dispute that the complicated tracking and allocation of investments and costs between regulated and nonregulated activities and the apportionment between interstate and intrastate jurisdictions play no role under price cap regulation in determining whether BST's rates are just, reasonable, and nondiscriminatory at either the federal or state level. BST's compliance with these rules, thus, is not necessary to the Commission's rate-setting goals, and forbearance from continued enforcement must be granted.

---

[63] *See* 47 U.S.C. §§ 160 (a) and (c).

1. <u>The Commission does not rely on cost assignment data to set BST's prices.</u>

As the Commission itself observed when it adopted price cap regulation, cost calculation is not a part of the price cap paradigm:

> . . . incentive regulation relies in the first instance on regulating *prices*. By establishing limits on prices carriers can charge for their services, and placing downward pressure on those limits or 'caps,' we create a regulatory environment that requires carriers *to become more productive*. Carriers that can substantially increase their productivity can earn and retain profits at reasonable levels above those we allow for rate of return carriers . . . . *If carriers fail to become more productive, they risk seeing their earnings erode.*[64]

Indeed, price caps, by design, impel carriers to police their own costs in order to achieve desirable earnings, and by adopting price cap regulation, the Commission and the states have eliminated the core logic underlying the cost assignment rules.

At the federal level, the price cap regime sets a ceiling on the prices BST may charge for its interstate services. The costs that BST incurs in providing these services have no bearing whatsoever on this price ceiling. Thus, BST's costs have only an income statement effect, identical to any company, in that they only determine profit or loss, which is not germane to price regulation under the Commission's price cap plan. Indeed, because the prices customers pay for interstate services are capped, the only constituency that should be concerned about BST's cost of providing service is BellSouth and its shareholders.

The continued need for the cost assignment rules under price cap regulation repeatedly has been called into question. As the Commission itself noted in *Computer III*, "because price cap regulation severs the direct link between regulated costs and prices, a carrier is not able

---

[64] *Second Report and Order, supra*, at ¶ 22.